Strategic Uses of Debt in Retirement

Neil Krishnaswamy, CFP®
July 2017

Given the choice, most retirees would not carry debt in retirement to avoid unnecessary risk.

Certainly, this isn't an irrational fear.

The stories of millions of homeowners facing the crushing burden of subprime mortgages during the financial crisis of 2007 to 2009 are still fresh in our memories. However, while the virtues of being debt-free are extolled, is it possible that we have taken debt avoidance to the extreme? Is it time to finally start seeing debt as a positive tool again? Can we acknowledge the tangible risks of carrying debt, but still use it responsibly to build and preserve wealth while achieving our retirement income goals?

Those are difficult questions to answer definitively because ultimately the answers are dependent on individual circumstances, but it may help to look at a couple examples where debt can be used intelligently in retirement.

Securities-based lending: Non-purpose, securities-based lending (SBL) facilities allow you to borrow against your liquid investable assets for almost any reason. There are a number of advantages to SBLs, including favorable interest rates, flexible payments and minimal costs to establish.

New York Times best-selling author Tom Anderson in his book *The Value of Debt in Retirement* shared a story of a retired couple who lived in a $750,000 house but wanted to downsize into a $300,000 condo. They didn't want to be forced to sell their house, nor did they want to have a long-term mortgage. Instead, they accessed $300,000 from a line of credit on their $1 million portfolio. They purchased the condo and took an additional $50,000 from the line of credit for improvements. They moved into the new property, sold their old home and used the proceeds to pay off the loan and stay mortgage-free.

The idea here is that SBLs can be very appealing for times when a bridge financing solution is needed. Of course, there are costs to implement this strategy. Suppose the couple had a 3.5 percent interest rate on their SBL and it took four months to sell the old house – they would pay a little over $4,000 in interest.

How does that compare to the alternatives? Should the couple have obtained a traditional mortgage instead? That probably isn't practical for this situation. You can estimate the lender and third-party fees of traditional home loans, but they would likely cost you much more in both time and money.

Should the couple have sold investments to raise the cash? This might not be advisable either, especially if they were in the middle of a market correction or recession at the time. Further, the tax consequences alone could be high. For example, if raising that $350,000 were subject to a long-term capital gain of $100,000, that would result in $15,000 in taxes, assuming it was taxed at a 15 percent effective rate.

The caveat to using an SBL strategy is that you must have a sizeable taxable portfolio. Tax-deferred accounts, such as IRAs or 401(k)s, are not eligible for this line of credit. There are also important risks to understand, so it's worth having a conversation with your financial advisor first.

Reverse mortgage line of credit: Let us shift gears and imagine a recently retired couple, both over age 62 with a $2 million dollar investment portfolio, a $500,000 home and no debt. They love their home and would like to stay there as long as their health permits. They need $100,000 from their portfolio to meet lifestyle goals and would like to delay the start of their Social Security benefits. But unlike the earlier example, this couple's taxable portfolio isn't large enough to qualify for a securities line of credit.

If a severe market correction occurs, bringing their portfolio value down 20 percent to around $1.6 million, should they cut back expenses and keep spending from the remaining portfolio? Perhaps so. But what if they had first established a home equity conversion mortgage, better known as a reverse mortgage (RM)? Here, they could have access to a line of credit of approximately 50 percent of their home value prior to the correction, or $250,000. They would have access to over two years' worth of living expenses, and they can give the market time to rebound.

If they don't draw upon their IRAs during this time, they're likely to save money on taxes too. IRA distributions are fully taxed as ordinary income. Reverse mortgage proceeds are tax-free. The market still may not recover fully by the time they need to start accessing their portfolio again, but market history would suggest they've tilted the odds in their favor. Our internal research shows that most market downturns have fully recovered in roughly two years or less on average, as seen in the chart below. The worst bear markets historically have averaged a little under 6 years to fully recover.

Largest Downturns				
% Change	Peak-Trough-Peak	# Of Months		
-83%	9/1929 - 11/1936	87		
-51%	11/2007 - 3/2012	53		
-50%	3/1937 - 3/1944	85	Average # Of Months - 68.2	
-45%	9/2000 - 10/2006	74	Average in years:	5.7
-43%	1/1973 - 6/1976	42		
Smaller Bear Markets				
% Change	Peak-Trough-Peak	# Of Months		
-30%	9/1987 - 4/1989	20		
-29%	12/1968 - 3/1971	28	Average # Of Months - 26.25	
-22%	6/1946 - 10/1949	41	Average in years:	2.2
-22%	1/1962 - 4/1963	16		

Note: Real returns were used for the 1929-1936 timeframe due to deflation.
Source: Internal study; Data from DFA Returns 2.0

There are several other ways to use reverse mortgages in your retirement income plan, such as setting up a contingency fund for unexpected spending needs or providing larger inheritances for heirs. The upfront costs of RMs can be rather high, but most of these costs can be rolled to the RM balance itself and not be incurred out-of-pocket. It may not be worth getting an RM if you plan to move from your current home in the near future. Your financial advisor can help you understand the requirements to obtain a reverse mortgage and the risks of maintaining one.

To conclude, these are just a couple of strategic debt approaches to consider in retirement. Each provides access to cash without a forced payback period that starts immediately, unlike traditional amortizing loans (home mortgage, car loan, etc.).
These solutions can provide liquidity and flexibility.

The amount of debt you should use in retirement will be specific to your needs and individual situation. Your financial advisor can help you look at your whole balance sheet and identify a safe debt ratio that's appropriate for your stage of life and risk tolerance. Advisors can also be a tremendous aid in helping you identify the right type of debt to obtain and make sure you're never overleveraged.

Human nature can make it easy for some to abuse debt and get overleveraged. In that case, debt can be destructive. But if used within a holistic debt strategy, your retirement outcomes can be improved.

Finally, if you choose to be completely debt-free in retirement, that really is great. But we encourage you to keep an open mind and learn how prudent use of debt, under the supervision of a qualified financial professional, can benefit you.

Sources:

1. The 2007-08 financial crisis in review: http://www.investopedia.com/articles/economics/09/financial-crisis-review.asp
2. Securities-based lending: http://www.investopedia.com/terms/s/securitiesbased-lending.asp
3. The value of debt: http://www.thevalueofdebt.com/the-books/the-value-of-debt-in-retirement/
4. Bridge financing: http://www.investopedia.com/terms/b/bridgefinancing.asp
5. Closing costs calculator: https://www.bankofamerica.com/mortgage/closing-costs-calculator/
6. Investor alert: Securities-backed lines of credit: https://www.sec.gov/oiea/investor-alerts-bulletins/sbloc.html
7. Home equity conversion mortgages for seniors: https://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/hecm/hecmhome
8. Reverse mortgages: https://www.irs.gov/help-resources/tools-faqs/faqs-for-individuals/frequently-asked-tax-questions-answers/other/for-senior-taxpayers/for-senior-taxpayers
9. 5 ways a reverse mortgage can help your retirement: https://www.forbes.com/sites/nextavenue/2016/10/12/5-ways-a-reverse-mortgage-can-help-your-retirement/#67e222bb1461
10. Amortized loan: http://www.investopedia.com/terms/a/amortized_loan.asp?lgl=myfinance-layout-no-ads

OKLAHOMA CITY, OK
9108 N. Kelley Avenue
Oklahoma City, OK 73131

OLD LYME, CT
187-B Boston Post Rd.
PO Box 623
Old Lyme, CT 06371

FRISCO, TX
2601 Network Boulevard,
Suite 400
Frisco, TX 75034

SAN ANTONIO, TX
7373 Broadway,
Suite 400
San Antonio, TX 78209

ExencialWealth.com